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This newsletter aims at discussing estimated tax for individuals and related planning tools.

ESTIMATED TAX FOR INDIVIDUALS

To pay or not to pay - That is the question! The federal income tax system is a "pay as you go" system. In general you're required to pay tax over the course of the year because the IRS wants its money every quarter, rather than waiting for you to file your annual returns. Most people meet this requirement without really thinking about it because of tax that's withheld from their wages. But you may need to make estimated payments if you receive:

- Self-employment income
- Investment income (selling stocks, receiving capital gains on investments, etc.)
- Rental property income
- Commission, fees or royalties
- Unemployment compensation (where taxes have not been withheld)
- Retirement income (withdrawals from an IRA or monthly pension payments)
- Tips
- Sick pay and certain types of disability pay (where taxes have not been withheld)

- or any other type of income that isn't subject to withholding. You may incur a penalty if you don't make quarterly payments of estimated tax.

Who Must Pay?

The general rule is that you have to pay estimated tax if your withholding and credits do not cover 90% (special rule for farmers and fishermen: If at least two thirds of their gross income for 2005 or 2006 is from farming or fishing, 66-2/3 is to be substituted for 90%) of the tax to be shown in your 2006 tax return but there are exceptions:

1) No estimates are required if the amount due after subtracting withholding and credits will be less than $1,000.
2) In general, no estimates are required if your withholding and credits add up to at least as much as your prior year's tax. We call this **prior year safe harbor**. Therefore, you do not have to pay any estimated tax for 2006 if you meet all the following conditions:
    a) You had no tax liability for 2005.
    b) You were a U.S citizen or resident for the whole year.
    c) Your 2005 tax year covered a 12-month period.

The second exception is particularly important. If you receive a large amount of investment income in one year — for example, you sell stock at a large gain — you may not be required to pay estimated tax even though you owe a great deal of tax that year. You may be able to delay your tax payment until April 15 because of the exception for the prior year's income. This rule often permits taxpayers to avoid making estimated payments if they receive a large sum of income on a one-time basis.

Example: Suppose, in a normal year your withholding is enough to cover your income tax — in fact, you usually get a small refund. In 2006 you sell your collection of rare stamps for a gain of $100,000. Despite the huge increase in income, you don't have to make estimated tax payments if your withholding and credits add up to at least as much as your prior year's tax.

The majority of people who pay estimated tax rely on the prior year safe harbor. It has some major advantages over actually estimating the current year's tax:

- **It's simple.** You don't have to track down a lot of numbers or do any complicated calculations if you use this method. All you need to know is the total tax from the prior year and the amount of withholding and other credits you'll have this year.
- **Limited guesswork.** When you base your estimated tax on the prior year's tax, instead of 90% of the current year's tax, you start from a much firmer base.

Higher Income, higher percentage: There is a rule that requires taxpayers with adjusted gross income above $150,000 on 2005 return ($75000 if your filing status for 2006 is married filing separately) to pay110% of the prior year's tax (not just 100%) when applying the prior year safe harbor. This rule does not apply to farmers and fishermen.

There are two situations where you may choose not to use the prior year safe harbor.

Current Year Tax Will Be Lower

If you have good reason to believe that 90% of your current year's tax will be significantly lower than your prior year's tax, you'll pay a lot more than necessary if you rely on the prior year safe harbor.

Example: In 2005 you had unusually high income because you exercised nonqualified stock options. You expect your income to be $90,000 lower this year. If you use the prior year safe harbor for 2006, you'll pay more than necessary, so it makes sense to base your 2006 payments on 90% of the current year estimated tax.

The main reason not to pay more than you have to is that you lose the use of your money between the time you pay the estimate and the time you would have sent payment with your return. You should be able to earn at least a little bit of interest during that time.

Current Year Tax Will Be Higher

Some people aren't comfortable with the notion that they'll owe a huge tax bill in April. And if anything happens to the money before April 15, and you're not able to make the payment then, you're in trouble. Some people ***choose to make voluntary payments*** so that they know they won't get into that situation.

Which approach is Better?

Paying the minimum or making voluntary payments - depends on your personality and your circumstances. Consider the following example:

Example: You normally don't pay estimated tax because almost all of your income is from wages subject to withholding. In August 2006 you sell stock and expect to owe $10,000 tax as a result of gain. But you don't have to pay estimates because your 2006 withholding and credits will be at least equal to your 2005 tax.

You have several choices, including the following:

- You can invest $10,000 in an interest bearing account until April 15, 2007 when the tax is due. This way you can make a little profit on the money before sending it to the IRS. There's a danger, though. If you start with this intention, but end up spending the money in a Casino in Vegas, you may wake up with a headache on April 15, 2007.

- You can send in a single estimated payment of $10,000 at a time when you're flush with money from stock sale. This approach is easy, and may seem relatively painless. It's also very safe: this approach assures that you won't somehow lose or spend the money before you file your tax return.

- You can send the payments in parts as per your convenience before making the final payment on April 15,2007 when the tax is due. You may prefer this approach if you don't like the idea of writing a single check for $10,000 to the IRS. And this approach gives you the flexibility to reduce later payments if you have a capital loss or other reduction in taxable income later in the year. There's a little more paperwork involved in this approach though, but more opportunity to use the money before April 15, 2007.

They're all equally acceptable approaches to the IRS. If you find yourself in this situation, you need to make your own decision based on your comfort level and money management skills.
We will continue this topic in our next newsletter, please stay tuned…

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Sincerely,

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